

Manager Commentary

EM Debt Vulnerable to Rising Rates and USD Strength in June

By: Eric Fine, Portfolio Manager

Overview

In our opinion, emerging markets (EM) debt total returns remain vulnerable to a “double-whammy” of rising U.S. Treasury yields and the ensuing U.S. Dollar strength. Although a few specific buying opportunities (e.g., some selected high-rated hard-currency bonds and Philippines local-currency bonds) may have emerged, a generalized buying opportunity (e.g., Mexico local currency) has presumably not yet emerged.

This sell-off is technically-driven, in our opinion. EM debt attracted significant inflows as investors seemingly sought countries with stronger fundamentals (fiscal policy, lower debt ratios). In addition, it appears as though many EM central banks allowed more foreign exchange (FX) appreciation to go through the spot market than prior to the 2008 crisis. It is possible that U.S. growth is generating the duration sell-off (the “great rotation” theory), but unlikely, in our opinion. First, countries that guarantee vulnerable financial systems rather than let them fail, and don’t address the causes of any original insolvency, tend to grow slowly with high inflation for long periods of time. Second, we do not see any “taper” behind the rates sell-off. Here, we see very straightforward game theory, namely, we believe that the Fed will “taper” if they can, and won’t if they can’t. The only issue in our view is what pain threshold in which asset price will trigger the “I can’t taper any more” reaction from the Fed. This may add to the troubles for EM debt, as their weakening means little to U.S. monetary authorities focused on U.S. risk-asset prices. Anyway, the EM debt market appears to us to be punishing the most crowded positions, as evidenced by Latin America’s underperformance relative to Asia, for example.

Declining commodity prices (particularly oil) could be another result of a stronger U.S. dollar or, worse, a reflection of weakening Chinese demand, further pressuring the EM bond market. EM debt appears to be over-represented by commodity exporters, relative to the commodity-importers that generally characterize EM equities. We think that commodity prices, too, have benefited to some extent (the amount is debated) from an investor search for a stable store of value. This, plus the fact that commodities are priced in U.S. dollars and the impact of a slower growth in China, does point to potential risks of falling commodity prices and, hence, further potential risks to EM debt fundamentals.

In the longer term we believe Treasury sell-offs are generally positive for EM macroeconomic fundamentals, as they may reflect improving final demand. In our last monthly update, we analyzed the last 16 bear markets for U.S. Treasuries, and found that on average EM debt (hard and local) has generated total positive returns during those bear markets, even though the Barclays Aggregate Bond Index generated negative returns. Despite this historical record, though, we believe that low spreads in hard-currency debt mean that such a record will not likely be repeated. We are only pointing out the record for its own sake and to reinforce the point that rising yields have the potential to be positive for debt that has value. Also, those with mean-reversion biases might argue that EM’s underperformance in the current bear market for duration, compared to its performance in earlier bear markets, may signify that it is poised to revert to its mean (and rally).

Although EM debt remains vulnerable, we do not see a bursting bubble nor do we see EM economies entering adverse feedback loops, as their balance sheets and policymakers have been honed by their own crises, and tested (more-or-less successfully) by subsequent crises in developed countries (e.g., U.S., Europe). This is not Latin America in the 1980s, when Latin America had excessive debt that was U.S. dollar-denominated and met a rising-rate environment. This is not Asia in the late 1990s, when loose policy allowed banking and real estate assets to become overvalued, which then met another bout of U.S. rate hikes. We are not saying higher rates are generally good for bond markets. We are saying we believe that higher rates may trigger crises due to a countries’ initial conditions, and in EM we believe that these are largely okay.

As mentioned, EM economies generally have lower debts and deficits, more inflation-focused central banks, and higher real interest rates. We think that higher real rates and stronger balance sheets than developed markets are hard to argue with in the long run. EM debt, in our opinion, will potentially be a larger part of global bond portfolios on a secular basis, and central banks will be a big part of this demand, as they seek bond markets backed by strong fiscal stances and central banks that protect the real value of money (relatively). These secular trends look set to be set-back, but not derailed, in our opinion.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

Our translation of this view for the portfolio involves the following:

- Developing an active range for cash levels to seek to take advantage of buying opportunities as well as tradable rallies.
- Diversifying away from some commodity exporters (we recently closed our Russia local exposure).
- Diversifying away from high-beta and illiquid securities.
- Focusing on high-rated U.S. dollar debt that in our opinion won't suffer from a U.S. dollar rally and might benefit from spread tightening if U.S. yields really are rising due to strong growth.

This "risk off" is different than the one we discussed in first quarter of 2013. The last "risk off" we worried about (March 2013), was not one in which U.S. yields rose. As a result, we could accommodate the risk we saw by increasing our allocations to high-rated, hard-currency debt where if the U.S. dollar rallied it did not matter and if U.S. yields declined you could actually benefit. This helped us perform during that risk-off period. The current risk-off period (assuming it is not over), though, is characterized by both the U.S. dollar rallying and yields rising, so there is no obvious place to re-allocate as we did last time. As a result, raising cash is one answer. We may allocate to some EM bond markets that sell-off too much in the near term, but the big lowering of cash would likely come when we believe Mexico becomes attractive again (using Mexico as both a specific example of where we'd like to invest, and also as a barometer of emerging markets foreign exchange generically), which we discussed above.

Commodity prices are a key translation mechanism from the U.S. dollar, U.S. rates, and global demand. The variable through which this particular risk-off period might affect us is commodity prices, as a strong U.S. dollar is generally consistent with declining commodity prices. As a result, we believe we have a portfolio now that is a barbell of commodity exporters and importers.

For the exporters, we have high nominal and real yields that generally carry during periods of instability, and may revert the moment there is stability. In addition, we believe they have strong balance sheets that may back a relatively stable currency (which inflation-focused central banks implement). Nigeria in local currency, and Brazil in inflation-linked local currency (with the currency risk hedged) are expressions of this.

On the other end, the importers, we have high real yields (not high nominal yields, which is a short-term risk) that could potentially become even higher if commodity price declines are persistent. So, we believe the protection of high real rates is already there, and disinflation or deflation will only potentially strengthen that. Any period of stability would likely see the real yields decline, in our view (i.e., rates rally). Europe and Asia seem to be nice locations for this.

In Europe we have a still-deflationary region with countries such as Poland already in outright deflation. Romania is our preferred expression of this as they appear to have the highest real yields, as well as a recent government and IMF program. The Philippines is another country with high real yields that could potentially benefit from any decline in global inflation.

We should emphasize that we do not have generalized theories on the U.S. dollar, commodity prices or global interest rates, at least not to start. Our process is to find countries where we see value in their debt, and only then test the asset prices we like by asking "what if the market's worries about such-and-such continue?" Of course we have opinions on these broad variables, but my point is that that is not the starting point of the portfolio. For example, Russian local currency debt is no longer in the portfolio due to its seemingly low real yields and because we see the country's budget as generally too optimistic about oil prices (current prices are below their assumption, which is not true for other countries) when we test it for this scenario.

When will be the time to be directionally bullish? Our first response to this question is that we anticipate three phases to any stabilization and strength that comes to EM debt. During phase 1 we anticipate a high-rated U.S. dollar debt rally, due to its liquidity, its tenure as an asset class, its lack of vulnerability to a U.S. dollar rally, and the low risk of default for high-rated sovereigns that would normally be another driver of weakness. During phase 2 we anticipate high-rated local debt rally (mostly Asian), for similar reasons – fundamentals and ratings are the highest in EM, and as long as global growth is generally on track, their idiosyncratic features should dominate. During phase 3 we anticipate "the rest" stabilize and rally. These may be names ranging from Venezuela in hard-currency to Peru in local-currency. Here, beta and illiquidity dominate during crisis periods and having a fundamentally-based process (or listening to it) is just inconsistent with current market behavior.

Our second response is that our goal is not necessarily to call a bottom and trade accordingly. Instead, we are maintaining our focus on the bottom-up, and letting top-down (e.g., oil price declines) lead to tests of which parts of the portfolio are vulnerable, rather than driving the portfolio process. As a result, during the current phase, we anticipate raising and lowering cash, increasing or reducing our FX hedges (we are currently hedging all of our Brazilian real risk, and raising and lowering our hedge on Mexican peso risk depending on market developments), all while increasing our exposure to "Phase 1" asset prices.

Our third response is that U.S. curve steepness points to the U.S. 10-year hitting 3%, in our opinion. The difference between the U.S. 10-year and 2-year yield over the past four decades has not been steeper than 300 basis points and with the Fed keeping the policy rate near zero into 2015, this provides a potential ceiling on the 10-year just over 3%. We believe it would take the market pricing of a rate hiking cycle (not just an end to quantitative easing) to get the 10-year significantly higher.

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Mutual Funds

Our fourth response is that, anecdotally, we believe the U.S. 10-year needs to stop selling off – not to rally – for EM debt to stabilize. This was a consistent refrain from managers of local pension funds who have a natural bid for duration...but are waiting to pull triggers. This is consistent with our general stance that a buying opportunity is seemingly brewing...and is a nice reminder that some countries do not necessarily depend on their central banks for government financing.

Exposure Types and Significant Changes

- During the month, we increased cash to around 11.1% from around 9.0%. Do not over-interpret this, as we were shifting the portfolio away from local-currency and towards hard-currency, and month-end happened to be on a day when we were shifting the portfolio. The main point is that cash will rise and fall as we navigate this transition.
- We increased our exposure to hard-currency debt and reduced local-currency debt.

Biggest Country- and Bond-Level Changes

- Our top five country exposures didn't change significantly, with one key switch – Philippines (local) in, Venezuela (hard) out, and Uruguay (local) reduced. Our top five are now Nigeria (local), Mexico (local and hard), Brazil (local), and Uruguay (local), and the Philippines. Last month, our top five included those above, with Venezuela being a top allocation.
- We closed our exposure to Venezuela simply due to its high-beta. It shows up as cheap in our models, and high-yielding hard-currency debt is hard to find. But, it is popular and has pretty consistently traded with a beta to the market and to U.S. Treasuries. As a result, we reluctantly don't own it, until we think that we are in "Phase 3" of any stabilization process (other than tactical investing).

- We reduced our exposure to Uruguay in local currency. This was a long-held position. It was reduced due to ongoing pressure from Brazil (via currency weakness from this key trading partner), as well as our opinion that Uruguay is not likely to be the first asset price to rally on signs of stability. This is partly due to ongoing and pent-up pressure from a problematic Brazil, but also due to government policy which has essentially put a limit on currency appreciation. This means that any upside is from the bond price (yield declining), and we see this as a "Phase 3" phenomenon.
- We also continued to increase our exposure to Philippine local.
- Our Brazilian real and Mexican peso risks have been actively hedged, with a bias to fully hedge the real and partially hedge the peso. Some of the Euro risk in our European exposure has been hedged.

Fund Performance

For June, the Fund returned -8.77%, compared to -4.13% in the local-currency index (GBI-EM Index), and -4.91% in the hard-currency index (EMBI Index). The Fund's biggest winners in June were our Euro hedge and small Indonesia and China corporate bond allocations. The Fund's biggest losers were Venezuela (hard), Philippines (local), and Nigeria (local). The market's best performers of the past month were Belize, Ecuador, and Pakistan in hard currency, and China, Hungary, and Mexico in local currency. The markets' worst performers of the past month were Egypt, Uruguay, and Peru in hard-currency, and Brazil, Peru, and South Africa in local-currency.

Average Annual Total Returns (%) as of June 30, 2013

	1 Mo*	YTD	Life
Class A: NAV (Inception 7/9/12)	-8.77	-8.50	1.62
Class A: Maximum 5.75% load	-14.00	-13.74	-4.20
GBI-EM Index	-4.13	-7.15	--
EMBI Index	-4.91	-7.77	--

Average Annual Total Returns (%) as of March 31, 2013

	1 Mo*	YTD	Life
Class A: NAV (Inception 7/9/12)	-0.30	2.89	14.27
Class A: Maximum 5.75% load	-6.07	-3.01	7.72
GBI-EM Index	-0.52	-0.12	--
EMBI Index	-0.62	-2.26	--

Expenses: Class A: Gross 1.67%; Net 1.25%. Expenses are capped contractually until 05/01/14 at 1.25% for Class A. Caps exclude certain expenses, such as interest. The tables present past performance which is no guarantee of future results and which may be lower or higher than current performance. Returns reflect applicable fee waivers and/or expense reimbursements. Had the Fund incurred all expenses and fees, investment returns would have been reduced. Investment returns and Fund share values will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. Fund returns assume that dividends and capital gains distributions have been reinvested in the Fund at NAV. Index returns assume that dividends of the Index constituents in the Index have been reinvested.

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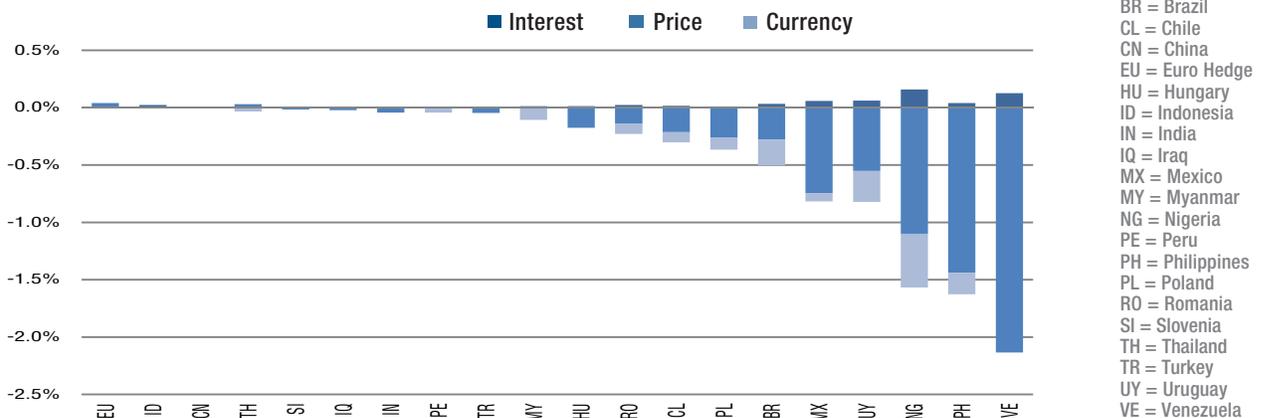
History of U.S. Treasury Sell-Offs - Impact on Emerging Market Bonds

Rising Rates Start Date	Rising Rates End Date	Length (Months)	10-Year Treasury Yield Change	Barclays Aggregate Index Return	GBI-EM Index Return	EMBI Index Return
1/31/1996	8/30/1996	7	1.4%	-1.8%	--	11.2%
11/29/1996	3/31/1997	4	0.9%	-1.5%	--	1.3%
10/5/1998	1/21/2000	16	2.6%	-2.3%	--	36.0%
11/7/2001	4/1/2002	5	1.2%	-2.4%	--	8.2%
6/13/2003	9/3/2003	3	1.5%	-4.5%	-3.7%	-3.8%
3/16/2004	6/14/2004	3	1.2%	-4.3%	-3.1%	-6.5%
6/1/2005	6/28/2006	13	1.4%	-1.3%	4.7%	4.8%
3/5/2007	6/12/2007	3	0.8%	-1.8%	7.1%	-0.9%
3/17/2008	6/16/2008	3	1.0%	-2.2%	-1.3%	0.6%
12/30/2008	6/10/2009	5	1.9%	-0.5%	7.3%	14.9%
11/30/2009	4/5/2010	4	0.8%	-0.5%	6.0%	4.9%
10/8/2010	2/8/2011	4	1.3%	-3.1%	-2.4%	-3.5%
9/22/2011	10/27/2011	1	0.7%	-1.7%	6.9%	3.0%
1/31/2012	3/19/2012	2	0.6%	-1.2%	1.3%	3.1%
7/24/2012	9/14/2012	2	0.5%	-0.7%	5.4%	4.0%
12/6/2012	3/11/2013	3	0.5%	-1.0%	3.7%	-0.3%
Average on periods with GBI-EM data			1.0%	-1.9%	2.7%	1.7%
Average on periods with EMBI data			1.1%	-1.9%	--	4.8%

Source: Bloomberg Research, Van Eck Global. Analysis as of May 2013.

The value of emerging markets bonds are more volatile than U.S. Treasuries. Treasury bonds are guaranteed as to the timely payment of principal and interest. The basis for the 10-year Treasury yield change was a generic Treasury security yield over the indicated time periods.

Price, Interest and Currency ("FX") Components of Fund Returns by Country



Source: Van Eck Global. Data as of June 30, 2013.

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Data Source: Van Eck Research, Factset. All weightings as of June 30, 2013.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the US Dollar, Euro or Yen). **Emerging Markets Local Currency Bonds** are bonds denominated in the local currency of the issuer. **Emerging Markets Sovereign Bonds** are bonds issued by national governments of emerging countries in order to finance a country's growth. **Emerging Markets Quasi-Sovereign Bonds** are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. **Emerging Markets Corporate Bonds** are bonds issued by non-government owned corporations that are domiciled in emerging countries. A **Supranational** is an international organization, or union, whose members transcend national boundaries and share in the decision-making. Examples of supranationals are: World Bank, IMF, World Trade Organization.

Any indices listed are unmanaged indices and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) tracks local currency bonds issued by Emerging Markets governments. The index spans over 15 countries. The J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI) tracks returns for actively traded external debt instruments in emerging markets, and is also J.P. Morgan's most liquid U.S-dollar emerging markets debt benchmark. The Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index representing most U.S. traded investment grade bonds. The index comprises government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturity of the bonds in the index are over one year.

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Please call 800.826.2333 or visit vaneck.com for performance information current to the most recent month end and for a free prospectus and summary prospectus. An investor should consider the Fund's investment objective, risks, and charges and expenses carefully before investing. Bond and bond funds will decrease in value as interest rates rise. The prospectus and summary prospectus contain this as well as other information. Please read them carefully before investing.

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